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TAGS: EFIN EREL ETRD PGOV PINR UP XH  
SUBJECT: WAKING UP TO UKRAINE'S FISCAL NIGHTMARE

REF: A. KYIV 1982  
    B. KYIV 1981  
    C. KYIV 1916

Classified By: Economic Counselor Edward Kaska for Reasons 1.4 (b) and (d)

11. (C) Summary. Payment delays have begun in Ukraine's regions and will get much worse in December 2009. January and February 2010 will be even darker, with no near-term causes for optimism in sight. Analysts from the IMF, World Bank, and EBRD ominously predict that, while social payments will continue (albeit unevenly) and the December 7 gas bill will likely be met, Ukraine's voting populace will be in for a rude awakening when the state treasury is drained. Public enmity will be concentrated at Prime Minister Tymoshenko, who has few apparent options left to avoid fallout from the budget crisis. End summary.

UKRAINE IN SURVIVAL MODE, SAYS IMF

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12. (C) The IMF's Kyiv-based budget expert Igor Shpak confirmed that Ukraine was essentially broke. Ministry of Finance plans to convert IMF Special Drawing Rights (SDRs) on November 13 were a last ditch effort to "survive" through November 2009 and make the December 7 gas payment. Shpak indicated that every Cabinet of Ministers meeting now began with a visit from the chairwoman of the state treasury, who deliberated with Tymoshenko and her ministers on how to "manually" distribute the few remaining state resources for 2009.

13. (C) December would be even more difficult, according to Shpak. Absent an unforeseen event, the state treasury will be unable to make a portion of its payments. In the IMF's view, there were three ways to avoid barren coffers in December: 1) find additional resources from the IMF; 2) beg or twist the arm of NBU governor Stelmakh to monetize; or 3) run arrears. The first option was "very unfeasible", while the second was unlikely, given the acrimonious relationship between the NBU and the GOU.

14. (C) Shpak acknowledged that cutting outstanding 2009 expenditures would be nearly impossible, since 90% of projected December payments were to so-called protected articles, such as transfers to localities, pensions, and entitlements. Arrears to regional budgets were "imminent", Shpak said. The IMF had already heard evidence of delayed payments of teachers' wages in Kyiv. There were anecdotes of widespread, general arrears throughout Ukraine's regions.

15. (C) Increased VAT refund arrears were also likely. The IMF official indicated that the GOU had been manipulating VAT

statistics, and that proper accounting for arrears was now intentionally non-existent. Shpak could not say whether the GOU figure of UAH 18 billion (\$2.2 billion) reflected overdue or total VAT refund claims. Either way, it was a figure that was likely to grow in the coming weeks.

¶6. (C) The IMF foresees a "nightmare" scenario in January and February 2010, when the GOU will encounter even worse payment problems. Revenues are due to "collapse" in January, Shpak said. Electoral politics surrounding the budget would get "very messy," he projected.

¶7. (C) In such an environment, it was unlikely the "incapacitated" Rada budget committee would pass the 2010 budget. The IMF has not ruled out the possibility that a last minute deal would be made among Ukraine's authorities, similar to the "disastrous" pact made on December 26, 2008, that set in motion the unsustainable 2009 fiscal deficit. Since target dates for the draft 2010 budget already had been breached, Shpak predicted the GOU continue to try to gain control over early 2010 expenditures with the so-called provisional transition budget, the Ukrainian version of a continuing resolution (Ref A).

WORLD BANK: ARREARS INEVITABLE

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¶8. (C) Admitting it was difficult to know exactly how Tymoshenko would spend the IMF SDRs, World Bank senior economist Ruslan Piotkivskiy surmised that Naftohaz would likely use up to the equivalent of \$600 million in SDRs for the December 7 payment to Gazprom. This would leave the

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equivalent of \$1 billion in SDRs for outstanding budget allocations and/or the January 7 payment (Ref B). Piotkivskiy opined that, if pressed, Tymoshenko would choose to fund social payments over gas, while working hard to free up money from other sources to prevent a shut-off.

¶9. (C) The World Bank's Piotkivskiy argued that the NBU had some room to monetize without violating its IMF-backed net reserve floor or significantly adversely affecting inflation. Acknowledging political realities, however, Piotkivskiy said the NBU was unlikely to purchase government debt before the presidential election. In the World Bank's view, it was certain a future NBU governor (appointed by the newly elected president) would face significant pressure to monetize the deficit in 2010.

¶10. (C) Piotkivskiy said Tymoshenko would try to gain revenues from the issuance of short-term domestic securities, such as those auctioned in October at a punitive interest rate of around 30%. He cautioned that the domestic market would remain small and that yields would be driven sky high. Ultimately, such an auction could not be a viable substitute for other revenue sources.

¶11. (C) Piotkivskiy concluded that the GOU would be stuck with an outstanding (roughly \$2 billion) deficit in December, after it burned through IMF SDRs and issued small amounts of short-term government debt. Across-the-board arrears would inevitably result, likely for subsidies, transfers to local budgets, VAT refunds, and government goods and services.

EERIE RESEMBLANCE TO 1998, SAYS EBRD

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¶12. (C) EBRD's London-based senior economist Alexander Pivovarskiy suggested that short-term borrowings at exorbitant rates could help Ukraine get through fiscal difficulties during the election period. But they would put Ukraine in an extremely tight bind in April-June 2010, particularly if the IMF program remains off track or if international financial markets continued to be closed, preventing Ukraine from rolling over short-term debt. EBRD

director of policy studies Jeromin Zettelmeyer concurred, commenting that such a scenario bore an eerie resemblance to Ukraine's 1998 default.

¶13. (C) If there were a silver lining amidst the country's fiscal mess, Zettelmeyer said it was in the NBU's refusal to monetize government debt (Ref C). Done for "perverse" reasons of political competition between Yushchenko and Tymoshenko, Zettelmeyer noted that blocking deployment of NBU's reserves had given Ukraine a heightened chance of escaping a devastating currency crisis.

COMMENT

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¶14. (C) Separate conversations with the IMF, World Bank, and EBRD -- institutions whose lending programs in Ukraine are on the shoals due to GOU non-compliance -- reveal a startlingly clear picture of the country's coming difficulties. IFIs' portentous words of warning, combined with skittish market behavior, indicate that analysts are again pondering worst-case scenarios.

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